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Re: Cambridge Electric Light Company and Commonwealth Electric Company, D.P.U. 92-260 Joint request for an accounting ruling concerning the recovery of the costs of long-term power and transmission contracts ("capacity contracts"), pursuant to G.L. c. 164, §76 and 220 C.M.R. 1.04.

Dear Mr. Krathwohl,

On November 25, 1992, Cambridge Electric Light Company ("CELCo") and Commonwealth Electric Company ("ComElectric") ("the Companies") petitioned the Department pursuant to G.L. c. 164, §76 and 220 C.M.R. 1.04 to reconsider the current recovery mechanism for the Companies' capacity costs. The Companies are currently allowed to collect a representative level of capacity costs as established in their latest rate cases, through a roll-in to base rates. The Companies ask that this mechanism be changed to allow a fuel-charge type reconciliation between rate cases.

In their petition, the Companies argue that the roll-in method inaccurately projects both the magnitude and volatility of capacity costs. According to the Companies, these costs are substantial and the risk of mismatches is relatively high, so that it is difficult for the Companies to earn an acceptable rate of return. Over the next 5 years, absent any rate case adjustments, the Companies expect to undercollect costs by $28.8 million (CELCo) and $34.4 million (ComElectric). The Companies predict a pattern of increasing costs due to replacement, regulatory and refueling costs, which they argue are beyond their control, and are incurred to benefit ratepayers. Without some mechanism between rate cases to recover these costs, the Companies anticipate that: (1) they will be unable to recover their costs; (2) they will be subject to poor debt ratings; and (3) continued earnings erosion will result in more frequent filing of rate cases. The Companies argue that these results increase the risks associated with capacity costs.

Annual rate case filings are not the solution, the Companies argue. Instead, the Companies propose to modify the current accounting treatment to allow any variation in costs from the roll-in amount to be reconciled through the fuel charge mechanism, between rate cases.

The Companies argue that their proposal is consistent with the Department's goals to: (1) achieve an equitable allocation of costs among rate classes; (2) establish a level playing field for supply and demand resources; and (3) motivate utilities to obtain least-cost power. According to the Companies, the goal of proper cost allocation and price signals would be met because the reconciliation of any incremental amount would only be recovered on a kilowatthour ("kwh") basis between rate cases and would increase an average customer's bill by approximately 2.35 percent, while providing more accurate price signals to customers.

The Companies also assert that the costs at issue derive from pre-existing contracts which were approved by the Department and should be fully recoverable. Further, the Companies argue that Integrated Resource Management ("IRM"), the Request for Propsals ("RFP") process, and the lack of need for new capacity make the roll-in process irrelevant as an incentive to cost-effective acquisition of power, since all resources are on an equal footing in IRM.

The Companies claim that the roll-in mechanism is not necessary to ensure efficiency and prudence in their performance, which is monitored in other ways, e.g., performance reviews. As for the rationale based on the distinction between companies that are all-requirements and those that are not, the Companies point out that they purchase 89 percent of their power. The Companies therefore ask for an accounting change that will permit them to recover all prudently incurred capacity costs.

On March 20, 1993, the Department issued a notice, asking for public comment on this proposal by April 23, 1993. One response was received to this request for comments, from the Attorney General of the Commonwealth ("Attorney General"), who opposed the Companies' request. The Attorney General asserted that the proposal was inconsistent with the Department's precedent on this expense, and should therefore be denied. However, the Attorney General suggested that he would be willing to consider some alternative mechanism to allow the Companies to recover additional expenses associated with the nuclear refueling outage component of this expense. In response, the Companies, on May 5, 1993, made an alternative proposal for deferral of all capacity costs between rate cases, with the recovery and reconciliation of such expenses to be addressed in the Companies' next rate case. In response to this alternative proposal, the Attorney General on May 18, 1993, stated that deferral was unacceptable and was not the relief that he had in mind in his original comments.

The Department has reviewed the Companies' filing in this matter, the Attorney General's comments, and the Companies' alternative proposal for deferral of capacity costs that are not currently being recovered through base rates.

The proposal to allow reconciliation of any over- and under-recovery of capacity costs outside the current base rates is inconsistent with Department precedent and with historical test-year ratemaking. The Companies' request tracks almost verbatim the arguments in Cambridge Electric Light Company, D.P.U. 84-165-A (1985), which the Department squarely rejected. In D.P.U. 84-165-A, the Department rejected CELCo's argument that, if it was not allowed to maintain a Power Cost Charge ("PCC") for capacity costs, it should receive a Purchased Power Cost Adjustment ("PPCA"). The Department's standard is clear: only companies that are all-requirements customers of a wholesale generating company are allowed to use a PPCA to collect capacity costs. D.P.U. 84-165-A, at 104. This is based on the theory that such customers are not directly responsible for their own power supply planning or procurement and take power under a tariff (id. at 105). Because CELCo was not an all-requirements customer, the Department held that it was not eligible for a PPCA.

Alternatively, in D.P.U. 84-165-A, CELCo proposed a roll-in of capacity costs, with 90 percent of any variances to be reconciled periodically (id.). The Department evaluated this proposal in light of its goals that ratemaking treatment of capacity costs should: (a) establish the proper incentives for a company to purchase capacity only when it is the most cost-effective method of meeting firm ratepayer demands, and (b) provide an appropriate balance of incentives between capacity purchases, construction and Conservation and Load Management ("C&LM") (id.at 105-106). The Department rejected

CELCo's proposal on the ground that it would skew incentives towards purchases and would be inconsistent with test-year ratemaking (id.at 106).

Capacity costs were first rolled into base rates for CELCo in D.P.U. 84-165-A (1985) and for ComElectric in D.P.U. 88-135 (1989) and D.P.U. 90-331 (1991). In D.P.U. 84-165-A, the Department reconsidered Cambridge's cost recovery mechanism for capacity costs, since it (along with ComElectric) was the only non-all requirements utility that recovered capacity-related expenses entirely through the fuel clause at that time; this lag simply reflected the fact that CELCo had last filed a rate case in 1981.

Of the eight private electric utilities in the state, two: Eastern Edison Company ("EECo") and Massachusetts Electric Company ("MECo"), are all-requirements customers, which purchase all of their power from wholesale generating companies. These two companies recover capacity costs through (1) a roll-in to base rates of approved Federal Energy Regulatory Commission ("FERC") rates, pursuant to a rate case; and (2) a PPCA adjustment for any additional costs outside a rate case, e.g., capacity costs approved by FERC between rate cases. Under this mechanism, MECo and EECo are made whole for the capacity costs passed on to them by their wholesale suppliers, although their suppliers could be at risk for any incremental purchases of demand whose marginal costs are above tariff. This risk is usually short-lived, however, because the wholesale suppliers typically file annual rate cases.

The Massachusetts electric utilities which are not all-requirements customers, including the Companies, are allowed recovery of capacity costs for pre-existing contracts through a roll-in to base rates pursuant to a rate case, and for current or future purchases through the fuel charge between rate cases. No other reconciling adjustments are allowed. The only way to increase recovery for capacity costs in pre-existing contracts, then, is through a rate case. The Department affirms this policy and therefore rejects the Companies' proposal to reconcile capacity costs between rate cases.

The Companies' alternative proposal to defer capacity costs is inconsistent with Department precedent on deferral, articulated in Commonwealth Electric Company, D.P.U. 90-331, at 37-41 (1991), and is therefore also denied.

Although the Department rejects the Companies' proposals on alternative accounting treatment for capacity costs by means of an accounting ruling, it acknowledges the argument of the Companies that the Department's current policy on recovery of capacity costs may deserve reconsideration, in light of the Companies' current situation and current regulation. For example, the Department's bright-line rule of all-requirements status for pass-through of capacity costs does not take into account the Companies' high percentage of purchase power. At the same time, the capacity costs which the Companies are seeking to recover in this ruling are the costs of pre-existing contracts; in the current regulatory scheme, these are anomalies, since all capacity purchases are now subject to IRM and RFP rules, which would allow the Companies full recovery of all prudently incurred capacity costs.

Given the complexity of the issues, the investigation and reconsideration of capacity cost recovery are more appropriately done in the context of a rate case, in which all interested persons can fully develop the issues. At the same time, the Companies can begin the process of exploring alternative methods of treating capacity costs with interested persons, such as intervenors from prior rate cases, and the Attorney General. The Department encourages such efforts by the Companies and believes that they could be helpful in the Companies' next rate cases.

By Order of the Department,